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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 91

WELDON D. SMITH, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The majority and dissenting opinions in the Tax Court (R. 62-76) are reported at 17 T.C. 135. The opinion of the Court of Appeals (R. 80-84) is reported at 203 F. 2d 310.

JURISDICTION

The judgment of the Court of Appeals was entered on April 10, 1953. (R. 84-85.) The peti-

tion for a writ of certiorari was filed on May 25, 1953. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the Court of Appeals erred in holding that the taxpayer's activities of giving financial aid to, and participating in the management of, several corporations did not constitute a trade or business so that the amount of $38,220 lent by taxpayer to a corporation, which became a worthless debt in 1945, constituted a non-business bad debt deductible only as a short-term capital loss under Section 23 (k)(4) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the applicable statute and Treasury Regulations are set forth in the Appendix, *infra,* pp. 13-18.

STATEMENT

The pertinent facts, as found by the Tax Court (R. 52-62) and summarized by the Court of Appeals (R. 81-82), may be briefly stated as follows:

The petitioner, hereinafter referred to as the taxpayer, is an individual residing in Buffalo, New York. (R. 52.) In 1936, he became interested in Llenroc Farm which was then operated by the Houck family (a mother and three sons). The farm was located on the Canadian side of the

Niagara River near Buffalo, and its principal operation consisted of dairy farming and the raising of prize cattle. The Houck family was desirous of finding someone to assume business management of the farm. In January 1937, taxpayer and the Houcks formed a Canadian corporation known as Llenroc Farms, Ltd., which was capitalized at $20,000, with taxpayer putting up $4,000 cash and the Houcks contributing the farm property, animals and implements in payment for their stock. Each stockholder owned 20% of the stock. Taxpayer became the treasurer and general manager of Llenroc and supervised the personnel, purchasing, seeding plans, crop gathering, etc. He attended to these matters in the evenings, Saturdays, and Sundays. A farm manager was hired to take charge of actual operations, and he lived on the farm. Neither the taxpayer nor the Houcks used the farm as a residence or for vacations. (R. 57-58.)

In the summer of 1937, the cattle became infected with tuberculosis and were destroyed by the Government which paid Llenroc only a nominal amount. Each year, from the time of its incorporation, Llenroc's expenses were greater than its gross profits. In the years following his investment in Llenroc, the taxpayer advanced additional sums, totalling $38,220, as loans to the corporation. Llenroc became bankrupt, and in his 1945 income tax return taxpayer claimed deduction of

the $38,220 as a debt owed him by Llenroc which became worthless in that year. (R. 58-60.)

The taxpayer had invested money in several enterprises and investigated the possibilities of many more. For a period of ten years which began January 1, 1935, he was engaged in the performance of a contract to serve as general manager of Adam, Meldrum and Anderson Company, Inc., a department store in Buffalo. He owned a substantial amount of the stock of this corporation and served as a director and officer until 1941. He left some of his earnings on deposit with the corporation upon which he received 6% interest. (R. 52-54, 61.)

The taxpayer owned 49% of the stock of Adam, Meldrum and Anderson Cleaning Corporation (unrelated to the department store) and served as vice-president and treasurer until it was sold in 1944 or 1945. He spent several hours a day at the cleaning plant, and left earnings on deposit with the company. (R. 61.)

The taxpayer was a stockholder and director of Adam, Meldrum and Anderson State Bank and of Central Cleaning Plant, functions which merely required attendance at board meetings. He acquired a 25% interest in Central Cleaning Plant in the 1930's and still held it at the time of trial. He also left salary on deposit with Central Cleaning Plant. (R. 61-62.)

The taxpayer was a partner with his brother in the operation of a public garage. He lent money to this venture and participated in a managerial capacity. (R. 62.)

Subsequent to the year 1945, the taxpayer acquired 99% of the stock of the Oliver Gear Works in which he left money on deposit at interest. (R. 62.) He also owned and managed a business building in Buffalo. (R. 62.)

The Tax Court, six judges dissenting, found that the taxpayer was in the business of giving financial aid and personal services to business ventures and, therefore, that the $38,220 loan to Llenroc was connected with a business regularly engaged in by taxpayer. It held this debt to be a business bad debt deductible under Section 23 (k)(1), Internal Revenue Code. (R. 62-76.)

The Court of Appeals reversed, holding that the taxpayer's bad debt was a non-business debt deductible only under Section 23 (k)(4) which treats such losses the same as losses from the sale of capital assets. (R. 80-84.)

ARGUMENT

Whether the single question it presents is one of "ultimate fact," as the taxpayer first argues (Pet. 9-14), or a question of law, as the taxpayer alternatively urges (Pet. 14 *et seq.*), the decision below is clearly correct in holding that the loan to the Llenroc corporation could be deducted only as

a non-business bad debt. Conforming to principles established by this Court and not in conflict with any decisions of other courts of appeals, the decision does not merit further review.

1. The business of a corporation is not the "trade or business" of its organizers, stockholders, officers, and directors. Losses incurred by such individuals from investments in, advances to, or endorsement of the obligations of, a corporation are not deductible by them as losses in their trade or business. *Dalton* v. *Bowers,* 287 U. S. 404; *Burnet* v. *Clark,* 287 U. S. 410; *Van Dyke* v. *Helvering,* 291 U. S. 642, rehearing denied, 291 U. S. 650.[1] Personal activities in connection with

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[1] This Court affirmed *per curiam* the decision of the Ninth Circuit Court of Appeals in *Van Dyke* v. *Commissioner,* 63 F. 2d 1020, which in turn had affirmed *per curiam* 23 B.T.A. 946. The rationale of the *Van Dyke* decision was summarized in *McGinn* v. *Commissioner,* 76 F. 2d 680 (C.A. 9th), as follows (p. 681):

> In *Van Dyke* v. *Commissioner,* * * *, a promoter sought to carry over to the next fiscal year his losses in operating some of the corporations he had promoted on the ground that the losses were incurred in his business of promotion regularly carried on by him. On the authority of *Burnet* v. *Clark, supra,* and also of *Dalton* v. *Bowers, supra,* we held that his claim was unfounded. This decision was affirmed by the Supreme Court, *Van Dyke* v. *Helvering,* 291 U.S. 642, 54 S. Ct. 437, 78 L. Ed. 1040. These cases establish the proposition that a loss incurred by an officer of a corporation in conducting the business of the corporation is not a loss of the officer in-

investments in the stocks and bonds of various corporations, no matter how extensive they may be or how much time and effort are devoted to them, do not constitute a trade or business. *Higgins* v. *Commissioner,* 312 U. S. 212, rehearing denied, 312 U. S. 714. Following these principles, the court below was plainly correct in holding that taxpayer's activities as investor, manager, and creditor of the corporation, Llenroc, would not alone constitute a trade or business, and that they were not converted into a business by reason of his engaging in similar activities in connection with some other corporations and business ventures.[2]

As the court below pointed out (R. 83), Congress intended the term "trade or business" in Section 23 (k)(4) of the Code, the provision involved here, to have substantially the same meaning it has in Section 23 (e)(1), dealing with

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curred in a business regularly carried on by the officer for the reason that the occupation of being an officer of a corporation is not a business distinct from that of the corporation by which he is employed * * *.

[2] The Tax Court's findings show (R. 61-62) that at various times, both before and after the taxable year, the taxpayer invested in and gave some services to a total of six corporations. In addition to his corporate activities, the taxpayer operated a garage in partnership with his brother and owned and managed a business building individually at some undisclosed time. It may be assumed that he was in the garage business and the business of operating and renting a business building, but the loss in question here was not related even remotely to these businesses.

losses incurred in trade or business (Appendix, *infra,* pp. 13, 14). H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 76-77 (1942-2 Cum. Bull. 372, 431); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 90 (1942-2 Cum. Bull. 504, 573). See also Section 29.23 (k)-6 of Treasury Regulations 111 (Appendix, *infra,* pp. 14-18). Section 23(e) expressly distinguishes between losses incurred in a trade or business and losses incurred in transactions, "not connected with the trade or business," but entered into for profit; and this distinction applies equally under Section 23 (k)(4). It follows that broad dictionary definitions of "business" are of no aid to the taxpayer here and that taxpayer's reliance upon *Flint* v. *Stone Tracy Co.,* 220 U. S. 107, which employed such definitions in a wholly different context, is misplaced. In *Flint* v. *Stone Tracy Co.,* the Court was construing a statute levying an excise tax on corporations "engaged in business," and a generic definition of "business" as including all activities engaged in for "livelihood or profit" (220 U. S. at 171) was obviously appropriate. But, just as this sweeping definition was found inapposite by this Court in making the "dissimilar inquiry" into what constitutes a "trade or business" under Section 23 (a) of the Code (*Higgins* v. *Commissioner,* 312 U. S. 212, 217; *United States* v. *Pyne,* 313 U. S. 127, 129), so it was properly held inapplicable here. For the

decisive fact here is that the transaction in question, though entered into for "profit," was not connected in any presently relevant sense with a "trade or business" of the taxpayer.[3]

2. The several court of appeals decisions taxpayer cites (Pet. 14-21) as conflicting with the decision below are readily distinguishable on their facts. In *Commissioner* v. *Stokes' Estate,* 200 F. 2d 637 (C. A. 3d), and *Maloney* v. *Spencer,* 172 F. 2d 638 (C. A. 9th), the taxpayers' activities were not confined, like those here, to the mere investment in and management of corporations. Stokes was, as the Tax Court found, engaged in the business of exploiting patents, using corporations for that purpose. Spencer was, as the District Court had found, engaged in the business of acquiring, owning, expanding, equipping, and leasing food processing plants to corporations, so that losses arising in the conduct of this business were held deductible. In contrast, here, the taxpayer was not engaged individually in any such essentially unified "business" in the carrying on

[3] It should be noted, moreover, that, to be deductible as a business bad debt, a debt must be proximately related to the business in which the taxpayer is engaged at the time the debt becomes worthless. Section 29.23 (k)-6 of Treasury Regulations 111; H. Rep. No. 2333, *supra,* p. 77; S. Rep. No. 1631, *supra,* p. 90. As the dissenting opinion in the Tax Court shows (R. 73-75), there is no factual basis for concluding here that the taxpayer's activities of giving financial aid and managerial services to a few corporations amounted as such *in 1945* to a trade or business.

of which he employed corporations and incurred losses. For example, though he lent money to a few diverse corporations, the taxpayer himself testified (R. 35) that he was never in the business of lending money.

Similarly distinguishable — though probably erroneous as well in light of this Court's decisions in the *Dalton, Clark,* and *Van Dyke* cases, *supra*— are *Washburn* v. *Commissioner,* 51 F. 2d 949 (C. A. 8th), and *Foss* v. *Commissioner,* 75 F. 2d 326 (C. A. 1st), which, on similar facts, followed *Washburn.* The *Washburn* decision seems to have rested largely on the view (see 51 F. 2d at 953) that a corporation, the stock of which was sold at a loss which the taxpayer there was permitted to deduct as a business loss, was the *alter ego* of the taxpayer, its principal stockholder. This Court flatly rejected such a view in the cases cited, and other courts have since considered that *Washburn* has been overruled.[4] In any event, the factual situation in *Washburn* differed markedly from the one here. Washburn, maintaining an office with a complete organization for the purpose, devoted his entire time to the active personal management of the enterprises in which he had investments, receiving no salaries for these serv-

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[4] See *McGinn* v. *Commissioner,* 76 F. 2d 680, 681 (C. A. 9th); *White's Will* v. *Commissioner,* 119 F. 2d 619, 622 (C. A. 3d); *Du Pont* v. *Deputy,* 22 F. Supp. 589, 596 (D. Del.), affirmed, 308 U. S. 488. *Cf. Stuart* v. *Commissioner,* 84 F. 2d 368, 370 (C. A. 1st).

ices. Here, the taxpayer received salaries from the corporations of which he was an officer, a fact which in itself indicates that his services were given on behalf of the corporate business, not his own; he maintained no business office of his own; and he was not not so active in the management of the various corporations as were the taxpayers in *Washburn* and *Foss,* where, as this Court has observed, "the opinions turned on the extent of the taxpayer's participation in the management of the corporations in which investments were held." *Higgins* v. *Commissioner,* 312 U. S. 212, 217.[5]

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[5] The other court of appeals decisions upon which the taxpayer relies fail still more clearly to support the claim of conflicts requiring resolution by this Court. *Hughes* v. *Commissioner,* 38 F. 2d 755 (C. A. 10th), did not decide that the taxpayer there was in the investment banking business by reason of devoting time to his personal investments. The taxpayer there was a member of an investment banking firm to which he devoted 20% of his time, and by virtue of this both parties agreed that he was in the investment banking business. The only dispute was whether his other activities constituted other businesses in which he was engaged, and the opinion contains nothing of any pertinence here. *Miller* v. *Commissioner,* 102 F. 2d 476 (C. A. 9th), actually decided, in harmony with the later decision in *Higgins* v. *Commissioner,* 312 U. S. 212, that the management of personal investments was not a trade or business within Section 23 (a). Certiorari in *Higgins* v. *Commissioner, supra,* was granted because of conflict with *Kales* v. *Commissioner,* 101 F. 2d 35 (C. A. 6th), and the decision in the *Kales* case was thus inferentially disapproved by this Court when *Higgins* was affirmed. *Gilford* v. *Commissioner,* 201 F. 2d 735, decided by the court below

3. There is no merit to the contention (Pet. 9-14) that the Court of Appeals exceeded its power in reversing the Tax Court. The Court of Appeals did not question or overturn any of the facts found by the Tax Court but, taking them as found, it concluded that the taxpayer's activities did not amount to a "trade or business" within the meaning of Section 23 (k)(4) and principles established by this Court. The determination of whether the proper legal standard had been used by the Tax Court under the statute and applicable decisions was well within the scope of appellate review. *Helvering* v. *Rankin,* 295 U. S. 123, 131.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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HELEN GOODNER,
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Special Assistants to the Attorney General.

JUNE 1953.

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two months before the instant case (with Judges Chase and Clark sitting in both cases), involved the business of maintaining, servicing and renting eight buildings, activities so unlike those in this case as to require no further comment.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

* * * * *

(k) [as amended by Sec. 124(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Bad Debts.*—

(1) *General Rule.*—Debts which become worthless within the taxable year; * * *.

* * * This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * *

(4) *Non-Business Debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(k)-6 [as amended by T.D. 5458, 1945 Cum. Bull. 45]. *Non-Business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting therefrom shall be treated as a

loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23(k)(3). A non-business debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23(k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a

loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the non-busines debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct therof.

* * * * *

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Supreme Court of the United States

OCTOBER TERM, 1952

No. 91

WELDON D. SMITH, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR PETITIONER IN REPLY TO RESPONDENT'S BRIEF

Opinions Below

The opinions in the Tax Court (R. 62-76) are reported at 17 T. C. 135. The opinion of the Court of Appeals (R. 80) is reported at 203 F. 2d 310.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on April 10, 1953. (R. 84-

85.) The jurisdiction of this Court is invoked under U. S. C. Title 28, Section 1254 (1.) and Section 1141 (a) of the Internal Revenue Code, U. S. C. Title 26, Section 1141 (a).

Questions Presented

The questions presented are stated at page two of the Petition for a Writ of Certiorari filed by the Petitioner herein and will not be repeated here.

Statement of the Matter Involved

The statement of the matter involved appears in detail in the Petition at pages two through nine and will, therefore, not be repeated here.

Argument

The Commissioner has failed to comprehend the position taken by the Petitioner. There is not a *single* question presented, but rather two questions. The first is as to whether or not the Court of Appeals erred in its reversal of a decision of the Tax Court on a question of ultimate fact, based upon specific findings, and not clearly erroneous, as to what constitutes "trade or business" within the meaning of Section 23 (k) of the Internal Revenue Code. The second is as to whether or not the Court of Appeals erred in holding as a matter of law that the varied and extensive engagement in the management of, investment in, and loaning of money to corporate and non-corporate business enterprises, by an individual taxpayer over a long period of time, did not constitute a trade or business within the meaning of the section last mentioned.

There is no inconsistency whatsoever between these two questions. The first question is based upon the assump-

tion that what constitutes "trade or business" is a question of fact. That such is the case cannot be successfully denied. The regulations and decisions are clear on this point.

What constitutes negligence is a question of fact. There are, however, certain states of fact which the courts have held specifically to constitute negligence. There are certain other states of fact which the courts have held do not constitute negligence. By the same token, there are certain decisions holding that certain activities constitute engaging in "trade or business" as a matter of law; and it is our contention that in our case not only did the triers of the facts determine that the petitioner sustained a loss from a bad debt, the worthlessness of which was incurred in his trade or business, but that his activities, under the decisions, constituted engaging in "trade or business" as a matter of law.

1. It is apparent from the Commissioner's brief that both he and the Court of Appeals have misinterpreted the decisions of this Court. The cases cited by him are all cases where it was found that certain specific activities did not constitute "trade or business" within the meaning of Section 23 (k) of the Internal Revenue Code. They are all clearly distinguishable from our case, and some of them have been distinguished at length in the petition.

2. The brief filed by the Petitioner in opposition to the petition rather argues the merits of the case than the issue before the Court on this particular application, namely as to whether or not a writ of certiorari should be granted.

The Commissioner's effort in his brief to distinguish the cases cited in our brief decided by circuits other than the Second Circuit, on the subject of what constitutes a bad

debt, the worthlessness of which is incurred in a taxpayer's trade or business, constitutes the best argument for granting the petitioner the relief which he seeks. The Commissioner clearly demonstrates that this is a case where a writ should be granted.

It is respectfully submitted that the petition for a writ of certiorari should be granted.

August 12, 1953.

ROBERT J. LANSDOWNE,
Attorney for Petitioner.